

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Ashburn Analyst: Darrine Distefano Bill Number: SB 1523  
Related Bills: See Legislative History Telephone: 845-6458 Introduced Date: 02-19-2004  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Employer Hiring Credit/Employer With 100 or Fewer Employees

### SUMMARY

This bill would provide a hiring credit to employers with fewer than 100 employees.

### PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to stimulate the growth of small businesses and encourage job growth in areas that are under economic stress.

### EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective immediately upon enactment. The credit would apply to taxable years beginning on or after January 1, 2005, and before January 1, 2010.

### POSITION

Pending.

### Summary of Suggested Amendments

Department staff is currently working with the author's staff to resolve the implementation and policy considerations discussed below. Amendments 1 and 2 are provided to correct technical considerations.

### ANALYSIS

#### FEDERAL/STATE LAW

Existing federal and state laws allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer's business (e.g., including employee wages and benefits).

Existing state law provides various tax credits that are designed to provide tax relief for taxpayers who must incur certain expenses (e.g., renter's credit) or to influence behavior, including business practices and decisions (e.g., research credits). For instance, taxpayers who pay someone to care for their child so they can work are allowed a child and dependent care credit based on those expenses and the taxpayer's income.

#### Board Position:

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Department Director

Date

Gerald H. Goldberg

4/9/04

Under the Revenue and Taxation Code, existing state law provides a hiring credit for taxpayers conducting business activities within an Enterprise Zone (EZ), Local Agency Military Base Recovery Area (LAMBRA), Targeted Tax Area (TTA), and a Manufacturing Enhancement Area (MEA), collectively known as economic development areas (EDAs). A qualified employee must be hired after the area is designated an EDA and meet certain other criteria. The business may claim up to 50% of the wages paid to a qualified employee as a credit against tax imposed on the EDA income.

### THIS BILL

This bill would allow a credit for wages paid to a qualified employee by the employer. The credit would be available to the employer for the first five years of the qualified employee's employment. The credit percentage would be:

- Fifty percent of the qualified wages for the first year of employment.
- Forty percent of the qualified wages for the second year of employment.
- Thirty percent of the qualified wages for the third year of employment.
- Twenty percent of the qualified wages for the fourth year of employment.
- Ten percent of the qualified wages for the fifth year of employment.

This bill defines the following terms:

- "Qualified wages" is a portion of wages paid or incurred by a qualified employer during the taxable year to a qualified employee that does not exceed 150% of the minimum wage, as defined.
- "Minimum wage" is the wage established by the Industrial Welfare Commission.
- "Qualified employee" is a person who is initially employed by a qualified employer on or after January 1, 2005. It does not include a person who was initially employed after January 1, 2005, terminated, and then re-employed by the taxpayer.
- "Qualified employer" is an employer that meets the following criteria:
  - The principal office is located in California.
  - The principal office is not located in any of the following areas: EZ, MEA, TTA, or LAMBRA.
  - Employs 100 or fewer employees.

This bill would allow any unused credit to be carried over until exhausted.

This bill specifies any deduction allowed for wages paid or incurred would be reduced by the amount of any credit allowed.

### IMPLEMENTATION CONSIDERATIONS

It is unclear how the credit or the taxpayer would be treated if the taxpayer exceeds the 100-employee limitation after initially claiming the credit. Generally, credits include recapture provisions to resolve subsequent disqualification issues. A recapture provision would also prevent a taxpayer from releasing, and then subsequently re-hiring, an employee for an existing position.

This bill does not specify how long an employee must be employed for a taxpayer to qualify for the credit. As written, a taxpayer only has to hire an employee for one day after January 1, 2005, in order to claim the credit, although since the credit base is the amount of qualified wages, up to 150% of the minimum wage, the actual credit in such a situation would be rather small. The author may wish to add a minimum term employment requirement for the taxpayer to be able to qualify for the credit. Alternatively, if the author would prefer to let the credit computation address the term of employment issue, then the author might also want to consider using the employee's tenure, rather than the employer's taxable year, as the measure of the applicable percentage to apply to the qualified wage amount in calculating the credit. Finally, it is not clear if a seasonal or leased employee would qualify the taxpayer for the credit.

This bill does not limit the credit for a taxpayer with multiple affiliated entities since the prohibition on termination and subsequent rehiring of an employee only applies to the taxpayer, and not to other members that have similar business operations under the control of a single owner. As a result, a taxpayer could transfer or rotate an employee between affiliates and claim a credit for each transfer or rotation. The author may wish to add language that limits an employee to count once.

This bill uses the term "principal office" to identify a location outside of an EDA. It is not clear if this term means the location of an employer's headquarters or the location of where the trade or business is performed. Since the intent of this bill is to limit the credit to employers outside an EDA, the author may wish to use the term "trade or business" instead to eliminate confusion for the employer and the department.

This bill does not require the taxpayer to obtain or maintain any documentation to verify an employee's employment. Currently, the EDA hiring credits require the taxpayer to obtain a voucher for each of the qualifying employees as verification of the taxpayer's eligibility to claim the credit. Since the author intends to identify a targeted group for the employer to hire, some type of documentation, such as an eligibility form from the specified assistance program, should be maintained by the employer to verify eligibility for the credit for Franchise Tax Board audit purposes.

This bill does not limit the number of years for the carryover period. Without a limit the department would be required to retain the carryover on the tax forms indefinitely because presently the bill would allow an unlimited credit carryover period. Recent credits have been enacted with a carryover limitation since experience shows credits are typically used within eight years of being earned.

## **TECHNICAL CONSIDERATIONS**

The tax provisions specify a repeal date of January 1, 2011. The provisions in this bill are for calendar and fiscal years beginning on or before January 1, 2010. In order to retain the provisions "in law" until the day after the last day of the fiscal year beginning December 1, 2009, this date should be December 1, 2010. To correct this repeal date, Amendments 1 & 2 are provided.

Also, the bill defines the term "qualified employer" to identify the taxpayer who is eligible to use the credit. However, under the provision (subdivision (b) paragraph (3)) that restricts a qualified employer from "recycling" an employee on or after January 1, 2005, two terms are used: "taxpayer" and "qualified employer." For consistency, the author may wish to use "qualified employer" throughout the bill.

## LEGISLATIVE HISTORY

SB 1876 (Alpert, 2003/2004) would, among other things, create a Living Wage Opportunity and Revitalization Credit and repeal the EDA hiring credits. This bill is currently in the Assembly Revenue & Taxation Committee.

AB 2365 (Correa, 2003/2004) would allow a credit for wages paid to a qualified employee who is hired in the taxpayer's manufacturing trade or business. This bill is currently in the Assembly Revenue & Taxation Committee.

AB 475 (Cogdill, 2001/2002) would have allowed a small business that is located in a qualified area a credit based on employees' wages. This bill remained in the Assembly Revenue & Taxation Committee.

SB 2010 (Hurt, 1995/1996) would have allowed a credit equal to an unspecified percentage of qualified minimum wages that were paid or incurred by an employer. This bill failed passage in the Senate Revenue and Taxation Committee.

## OTHER STATES' INFORMATION

*Florida* allows businesses located in an EZ a credit based on wages paid to new employees. Other wage-based credits are offered to businesses that are located in high crime areas or in rural areas. Florida does not appear to offer a wage credit specifically for businesses with 100 or fewer employees.

*New York* allows a wage credit to a business that hires a full time employee (either one in targeted group or not) for a newly created job in an Empire Zone. New York does not appear to offer a wage credit for businesses with 100 or fewer employees.

*Illinois, Massachusetts, Michigan, and Minnesota* do not offer a wage credit to small business employers.

Most of these states offer assistance such as financial, marketing, licensing, finding employees, taxes seminars, and training to small businesses.

## FISCAL IMPACT

This bill would not significantly impact the department's costs.

## ECONOMIC IMPACT

### Revenue Estimate

It is projected that revenue losses for fiscal year beginning 2005/2006 will be on the order of \$500 million based on the current language of this bill. Losses are projected to grow significantly in the subsequent years as new credits are generated and unused credits are carried forward.

### Revenue Discussion

The revenue impact for this bill would depend on the following:

- Number of qualified employers with 100 or fewer employees not headquartered in an existing economic development area,
- New full-time or part-time (FT/PT) employees that begin working for small employers following the operative date of this bill, and
- The amount of available tax liabilities of qualified employers.

It is assumed that 90% of firms with 100 or fewer employers would qualify for this credit. Estimates assume an average of six employees per qualifying business. New hires are projected at a rate 5%, using a 1,500-hour year for qualifying wages at 110% of the minimum wage. The current minimum wage amount is \$6.75 per hour in California ( $6.75 \times 110\% = \$7.43$ ). The credit per employee in the first year would be 50% of the annual wage or \$5,500 ( $1500 \text{ hours} \times \$7.43 = \$11,200$  divided by 2 = \$5,600). It is assumed that approximately 125,000 new employees would be subject to this credit ( $125,000 \times \$5,600 = \$700 \text{ million} \times 6\%$  (wage expense tax deduction) = \$42 million.) Therefore in fiscal year 2005/2006, it is assumed the loss would on the order of \$500 million ( $\$700 \text{ million} - \$42 \text{ million} = \$658 \text{ million}$  rounded to an order of magnitude of \$500 million.)

The above estimate is presented as an order of magnitude due to several concerns regarding the author's intent, along with limited data presently available.

### **ARGUMENTS/POLICY CONCERNS**

This bill would require the taxpayer to reduce any wage deduction by the amount of credit taken. This would create differences between federal and California tax law, thereby increasing the complexity of California tax return preparation.

This credit would be limited to an employer whose principal office is located in California. Although the principal office could be the location of where the operation is managed, not where the work is performed, restrictions based on the location of a business could be subject to challenge as unconstitutional discrimination in favor of local commerce.

This bill does not restrict the wage credit to employees who are employed within California (and are thus themselves subject to California tax on their earnings).

### **LEGISLATIVE STAFF CONTACT**

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO SB 1523  
As Introduced February 19, 2004

AMENDMENT 1

On page 3, strikeout lines 8 and 9, and insert:

(e) This section shall remain in effect only until December 1, 2010, and as of that date is repealed.

AMENDMENT 2

On page 4, strikeout lines 24 and 25, and insert:

(e) This section shall remain in effect only until December 1, 2010, and as of that date is repealed.